

United States General Accounting Office

GAO

Report to the Honorable
Daniel K. Inouye, U.S. Senate

February 1989

ELECTRONIC FUNDS TRANSFER

Analysis of Proposal for Direct Deposit of Income Tax Refunds





United States
General Accounting Office
Washington, D.C. 20548

Information Management and
Technology Division

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The Honorable Daniel K. Inouye
United States Senate

Dear Senator Inouye:

This report responds to your October 12, 1988, request that we review and comment on two proposals submitted to you by a constituent. The constituent proposed that federal income tax refunds and other non-recurring payments be paid through electronic funds transfers (EFT).¹ As agreed with your office, we focused our work on the proposal to use EFT to electronically deposit federal income tax refunds directly into taxpayers' bank accounts. We also, at your office's request, obtained information on IRS' program for electronic filing of income tax returns, which includes an option for the direct deposit of refunds into taxpayers' bank accounts. Under this program, a taxpayer whose return is filed electronically and who is due a refund has the option of having the refund deposited directly into a bank account using EFT, instead of receiving a paper refund check.

The constituent's proposal presents a method for all taxpayers claiming a refund to receive that refund by direct deposit into their designated bank accounts. The proposal does not distinguish between returns filed electronically and returns filed on paper. The proposal also provides for IRS to mail an advance notice to the taxpayer of when the refund will be made. Since IRS already offers electronic refunds on returns filed electronically without an advance notice, this report addresses: (1) the direct deposit of refunds on returns filed on paper, (2) the mailing of an advance notice to both electronic and paper filers, and (3) information on IRS' electronic filing program.

No disagreement exists on the technical feasibility of the constituent's proposal to offer income tax refunds by direct deposit to taxpayers who file paper returns. However, IRS has raised several issues that must be resolved before the constituent's proposal can be made cost effective and practical for use by all taxpayers. First, according to IRS, a potential exists that taxpayers and IRS staff will make errors in transcribing the bank routing and transit number and the taxpayer's bank account number if the information is provided to IRS using paper returns. Second,

¹EFT involves the use of computer technology to electronically send and receive funds from one bank to another almost instantaneously. EFT eliminates mail handling and check clearing time and adds greater certainty to each transaction.

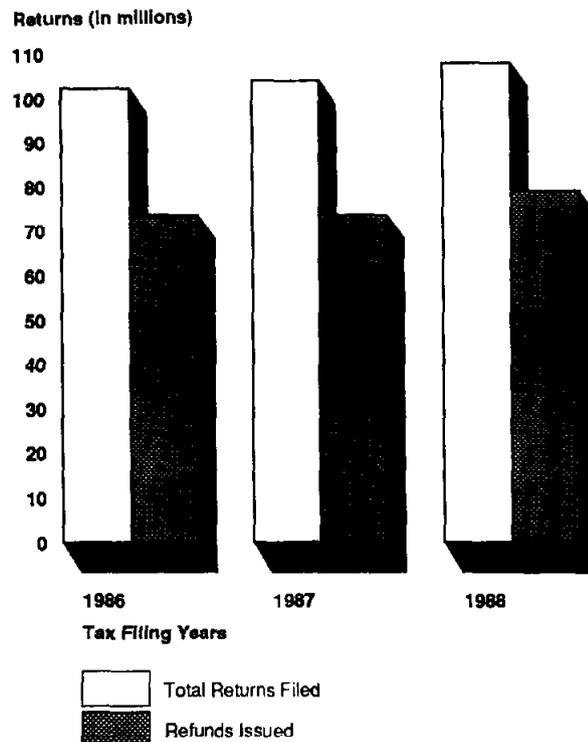
IRS believes the proposal would be costly to implement for paper returns. Third, IRS believes that the proposal's provision to notify the taxpayer by mail before making the electronic payment is unnecessary, costly, and could delay the receipt of the refund. However, IRS' Research Division is studying the direct deposit of refunds for taxpayers who file paper returns to develop a proposal that would ensure accuracy of the data and be cost effective.

Our review was performed in accordance with generally accepted government auditing standards. A description of our objectives, scope, and methodology is contained in appendix I.

IRS' Current Electronic Filing and Refund Program

IRS received over 100 million individual tax returns during each of the past 3 years. Over 70 percent of these returns received refunds as shown in figure 1.

Figure 1: Total Number of Individual Income Tax Returns Filed, 1986-1988, and Those for Which Refunds Were Issued



In the early 1980s, IRS decided that having professional tax preparers electronically transmit returns to IRS would be a practical and cost-beneficial alternative to mailing paper returns when a refund is claimed. According to the agency, the benefits of electronic filing would include: (1) reduced manual labor costs to process, store, and retrieve returns, (2) faster processing of returns, and (3) reduced interest payments for refunds to taxpayers who file timely returns, but are issued refunds after the interest-free period IRS has to process the refunds.

In 1986, IRS began a limited program allowing some professional tax preparers to send their clients' tax returns to IRS electronically. The program was tested in three metropolitan areas. Only returns claiming a refund were transmitted electronically. Tax preparers used previously approved IRS software to transmit the returns. In 1987, IRS added a direct deposit option to this program that allowed taxpayers the choice of receiving a refund deposited directly into a bank account using EFT or the standard paper check. IRS plans to continue expanding the program through 1990 when electronic filing with the direct deposit option will be available nationwide.

According to IRS, taxpayers who have their returns filed electronically may obtain refunds up to 3 weeks sooner than taxpayers who file paper returns. In addition, taxpayers choosing the direct deposit option may receive their refunds 1 to 4 days faster than if the refunds were mailed. We reported on the status of the electronic filing program in July 1988.²

As table 1 shows, the number of electronically filed returns and the number of taxpayers choosing the direct deposit option have increased steadily since the program began, and are expected to increase further.

²ADP Modernization: IRS's Progress on the Electronic Filing System (GAO/IMTEC-88-40, July 13, 1988).

Table 1: Growth of the Electronic Filing Program and Direct Deposit of Refund Option

Tax Processing Year	Locations/ IRS Districts Allowing Electronic Filing	Electronic Returns Filed	Locations/ IRS Districts Allowing Direct Deposits	Direct Deposits Requested
1986	3 ^a	24,800	0	
1987	7 ^a	77,600	3 ^a	12,140
1988	16	583,500	16	467,233
1989	48	2,228,000 ^b	48	
1990	63	4,414,000 ^b	63	

^aMetropolitan areas rather than IRS districts

^bEstimated

In the first year that the direct deposit option was offered, 20 percent of the eligible taxpayers requested the option.³ The second year, about 80 percent of the eligible taxpayers requested direct deposit. Significantly, about 98 percent of all direct deposit requests in 1987 were made in conjunction with obtaining a refund anticipation loan from a financial institution. Although similar statistics were not available for 1988, IRS officials believe that the percentage was also high. Under this loan program, a financial institution loans the taxpayer an amount equivalent to the refund, less loan charges. Arrangements are made for IRS to electronically deposit the taxpayer's refund into an account designated by the taxpayer to receive the refund and repay the loan.

Tax preparers use these loans as a selling point for the electronic filing of returns, but the loans themselves are available only from financial institutions, not the tax preparers. Although these loans are not a prerequisite to using the direct deposit option, tax preparers have commented to IRS that the loans are a necessary adjunct to make electronic filing and direct deposit attractive to taxpayers.

The Constituent's Proposal

The constituent's proposal is for the taxpayer to notify the IRS, when filing a tax return, of the desire to receive a direct deposit refund in the taxpayer's designated bank account. The proposal does not make a distinction between electronic and paper filing of tax returns. When filing the return, the taxpayer would provide the appropriate bank routing and transit number and bank account number by enclosing a printed

³As the table shows, taxpayers in only three metropolitan areas could use the direct deposit option in 1987. In those areas, 61,572 electronic returns were filed and about 20 percent of these requested direct deposit.

deposit slip or voided check or by writing the appropriate numbers on a place to be provided on the tax forms. The proposal also provides that the IRS mail to the taxpayer an advance notice of the electronic payment. The proposal states that the notice should be mailed 5 to 7 calendar days prior to the electronic payment and should give the date of the electronic payment and the identifying data of the taxpayer's bank. The constituent's proposal does not state the reasons for sending an advance notice. The constituent believes that the use of electronic funds transfer for refunds would benefit both the taxpayer and the government.

IRS' Comments on the Constituent's Proposal

There was general agreement among IRS officials that electronic funds transfer with direct deposit is technically feasible for paper returns at the current time. Most believe, however, that the proposal, if used for paper returns, has several problems that make it prone to potential errors and would cause a large increase in cost to the government. As discussed previously, IRS already offers electronic deposit of refunds for returns filed electronically.

With regard to potential errors, for example, IRS needs to know the bank routing and transit number and the bank account number to make a direct deposit of a refund to a taxpayer's account. According to IRS, a minimum of 26 digits are necessary for the direct deposit information. These digits would have to be copied accurately by the taxpayer from a check or deposit slip if the taxpayer provides the digits on the tax return. IRS officials believe that there is a potential for error on the part of the taxpayer in copying the digits correctly. Alternatively, to assure the correct digits are being provided to the IRS, the taxpayer could enclose a voided check or deposit slip with the tax return that contained the needed digits.

Regardless of how the bank information is provided to IRS by taxpayers filing paper returns, it must be entered into the computer system by IRS. IRS personnel would have to enter all the digits correctly into the computer. Again, according to IRS officials, there is a potential for errors occurring when entering the digits into the computer.

IRS officials commented that erroneous bank routing and transit numbers or bank account numbers could cause a direct deposit refund to be deposited into a wrong bank account. The IRS officials said such an error would be very costly to resolve. Further, IRS officials commented that sending in voided checks or deposit slips is not an acceptable option. This option is contrary to IRS' objective of reducing tax return processing

costs by developing and implementing programs that reduce the amount of paper received with tax returns.

Further, IRS said costs would increase to enter and verify the correctness of the additional information being entered into the computer. On the basis of IRS cost projections for both labor and machine use for entering the additional information, we estimate that this proposal could cost IRS over \$9 million annually if all taxpayers who filed paper returns and were due a refund elected to receive their refunds electronically.⁴ Our estimate was based on IRS' current method of manually keying the additional information into the computer system. This cost could potentially be reduced by the use of optical character recognition technology to read the additional information if the taxpayer enclosed a voided check or deposit slip, but we have not analyzed the feasibility of this approach. In this regard, IRS has a research project to explore the feasibility of optically reading specially formatted paper returns produced by a computer. IRS has not incorporated electronic refunds into this project at this time, but, according to IRS officials, this could be done at a later date.

Another point made by IRS officials about the cost to the government was the cost of the advance-notice provision. While IRS did not have a precise estimate of the cost to prepare and mail a notice to each taxpayer requesting a direct deposit, several IRS officials believed that the cost of mailing advance notices together with the cost of the electronic transfers would be more than the cost of providing only paper checks.

In addition, mailing an advance notice 5 to 7 days ahead of the electronic transfer of funds could delay the receipt of the refund by a few days. IRS officials said that the advance notice could not be generated until after IRS prepares the computer tape containing the list of refunds for electronic transfer. Since it takes only a few days to process the tape and accomplish the direct deposit into the taxpayer's account, the electronic disbursement might have to be delayed to coincide with the date on the advance notice. IRS officials further believe that the advance-notice provision would be an unnecessary procedure. Under the current electronic filing program, taxpayers who elect direct deposit do not

⁴IRS uses a double-entry process to verify the correctness of selected information being entered into the computer. This process would apply to the 26 digits, which would become 52 additional digits to be entered into the computer for each return. One keystroke is required to enter each digit. Therefore, since the estimated cost to IRS is about \$123,000 for the additional keystrokes per million returns, and since there were over 75 million paper returns in 1988 that received a refund, a cost of over \$9 million annually could be incurred.

receive an advance notice of when the refund will be deposited in the bank. IRS officials additionally stated that the banking community usually does not notify its customers at the time the direct deposit is made and banking customers accept this policy.

IRS officials also believe that there would be little time savings in issuing refunds by electronic transfer rather than by paper check for taxpayers who file paper returns. The direct deposit refund would arrive at the taxpayer's bank only 1 to 4 days before a paper check at the taxpayer's mailing address.

IRS' Research Division is studying the issue of providing direct deposit of income tax refunds to all taxpayers, not just to those who file returns electronically. A preliminary proposal is being developed for consideration and evaluation within the division. According to division staff, the proposal being developed would eliminate both the error potential and most of the cost to IRS. However, details of this preliminary proposal are not available because it is still in draft form. IRS officials believe it is inevitable with advancing technology that a practical and cost-effective solution will be found to allow all taxpayers the option of receiving tax refunds by direct deposit.

Treasury's Financial Management Service's Comments on the Constituent's Proposal

Officials of the Financial Management Service of the Department of the Treasury stated that the concept of direct deposit using electronic funds transfer for income tax refunds is technically feasible and is currently being done under the IRS electronic filing program. Under the current procedures, IRS provides the Financial Management Service with two disbursement tapes weekly. One tape is prepared for paper checks and a second is prepared for electronic transfers. The disbursement of funds is then made in accordance with the instructions from IRS.

According to Financial Management Service officials, the cost of preparing and issuing a paper check is 30 cents, and the cost of preparing and issuing an electronic transfer is 4 cents—a cost savings of 26 cents. Therefore, the Department of the Treasury encourages the use of electronic funds transfer. Financial Management Service officials said they are aware of the problems that the constituent's proposal would cause for the IRS if the direct deposit option were available to taxpayers filing paper returns. They said they have discussed the problems with IRS officials and have agreed that until a way is found to reduce error potential and cost, the direct deposit option should not be offered to taxpayers filing paper returns.

Federal Reserve Board's Comments on the Constituent's Proposal

We discussed the constituent's proposal to use electronic funds transfer for federal income tax refunds with an assistant director in the check and electronic payments section of the Federal Reserve Board. This official stated that the Federal Reserve does not have an official position on the use of electronic funds transfer for income tax refunds. Further, the official added that even though the concept is technically feasible, the Federal Reserve would defer to the Department of the Treasury on the merits of adopting or rejecting the constituent's proposal.

Conclusions

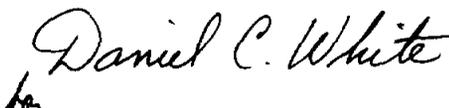
The constituent's proposal, as currently presented, is technically feasible for paper returns but several issues must be resolved before it is practicable and cost effective. The efforts currently underway in IRS' Research Division to study this problem and develop a practical alternative could help to ensure that the data are recorded accurately and the cost to the government is kept to a minimum. Such continued efforts are in the best interest of both the government and the taxpayer.

We have discussed the contents of a draft of this report with officials of IRS who agreed the information presented was accurate. We incorporated IRS' comments into this report as appropriate. We have also discussed relevant sections of a draft of this report with officials of the Financial Management Service of the Department of the Treasury and the Federal Reserve Board, who also agreed that the information presented on their positions was accurate.

We are distributing copies of this report to the Internal Revenue Service and the Financial Management Service of the Department of the Treasury, the Federal Reserve Board, and other interested parties upon request.

This report was prepared under the direction of Howard G. Rhile, Associate Director. Other major contributors are listed in appendix II.

Sincerely yours,


for Ralph V. Carlone
Assistant Comptroller General

Objectives, Scope, and Methodology

Our objectives were to review and obtain comments on a proposal developed by a constituent to use electronic funds transfer for direct deposit of federal income tax refunds. Specifically, we (1) determined the issues that IRS and the Financial Management Service of the Department of the Treasury would face in implementing the proposal for paper returns; (2) obtained from the IRS and the Financial Management Service their positions or comments regarding the proposal; (3) identified the proposal's impact, as seen by the IRS and the Financial Management Service, on refund service to the taxpayer; (4) obtained information on the status of the IRS electronic filing program; and (5) obtained the position of the Federal Reserve Board regarding electronic funds transfer for income tax refunds.

To accomplish these objectives, we obtained and analyzed applicable instructions and procedures governing IRS' current electronic filing program at IRS and obtained some statistics and cost data regarding the filing and processing of income tax returns. We also reviewed an IRS evaluation report of the electronic filing pilot project and obtained information on the expansion efforts of that program. We also discussed the constituent's proposal and aspects of EFT with (1) IRS officials located in the Research Division, the Returns Processing and Accounting Division, the Taxpayer Service Division, the Tax Processing Systems Division, and the Electronic Filing Project Office; (2) officials of Treasury's Financial Management Service in its Payments Management Division; and (3) an official of the Federal Reserve Board located in the Division of Federal Reserve Bank Operations.

Our review was performed in December 1988 and January 1989 in the Washington, D.C., headquarters of IRS and the Financial Management Service of the Department of the Treasury, and the Federal Reserve Board. This review was performed in accordance with generally accepted government auditing standards. We discussed the contents of a draft of this report with officials of IRS who agreed with the accuracy of the information presented. We have incorporated their comments in the report as appropriate. We also discussed relevant sections of a draft of this report with officials of the Financial Management Service of the Department of the Treasury and the Federal Reserve Board, who agreed that the information presented on their positions was accurate.

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